COMMONWEALTH OF MASSACHUSETTS DEPARTMENT OF PUBLIC UTILITIES

Investigation by the Department of Public Utilities on its own Motion into Rate Structures that will Promote Efficient Deployment of Demand Resources)))	D.P.U. 07-50
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INITIAL COMMENTS OF THE MASSACHUSETTS DIVISION OF ENERGY RESOURCES

I. Summary

The Division of Energy Resources (DOER) submits these comments in response to the June 22, 2007 order of the Department of Public Utilities (the Department) opening an investigation into "rate structures that will promote the efficient deployment of demand resources." Such rate structures would "sever the link between electric and gas companies' revenues and sales," a change that is commonly referred to as "decoupling."

DOER believes that decoupling, done properly, is fundamental to our state's ability to reduce energy costs and save money for consumers of all classes – residential, commercial, and industrial – going forward. Today, utilities have an incentive to maximize the sale of energy to their customers. This incentive undermines efforts to increase energy efficiency and serves to drive up energy costs across the rate base. The core purpose of decoupling is to put an end to that incentive, and to make it possible for new incentives to be built into utility rates in its place – namely, incentives to help customers maximize efficient use of energy and thereby reduce their energy costs. Investment in energy efficiency and demand management is the

single biggest thing the Commonwealth can do to curb energy costs, and it is essential to build incentives to encourage that investment into the rate structure.

At the same time, it should be recognized that decoupling, if not done properly, could result in undue protection of revenues for utilities without commensurate consumer benefit. It is incumbent upon the Department to ensure that any decoupling plan result in savings to consumers. DOER would not support any decoupling approach that does not result in net savings to consumers.

DOER recognizes that the creation of a decoupling regime that fulfills its promise is a complicated undertaking, and we look forward to participating over the course of the Department's proceedings on the matter. We take this opportunity to set forth a number of considerations we believe should govern the Department's inquiry; we include in the attachment answers to the Department's specific questions.

- 1. First, make the utilities indifferent to reductions in sales volume. In our view, a utility's revenues should be related to prudently incurred costs and not to the amount of electricity or gas it delivers. Decoupling should make the utilities indifferent to sales volume by eliminating the current incentive for utilities to maximize energy sales.
- 2. Next, make the utilities promoters of energy efficiency. Once the utilities have been made indifferent to increased energy efficiency, the Department should take the next step and incent them to maximize efficiency. Performance-based ratemaking should be changed to

include incentives for utilities to increase the deployment of energy efficiency measures as well as to improve their productivity and service delivery.

- 3. Retain volumetric pricing. Although rate design is a wholly separate matter from decoupling and one that we mention here only in passing, we would not want our rejection of sales volume as the basis for utility revenues to be understood as the rejection of volumetric pricing. Overall rates should continue to send price signals that encourage electric and gas customers to reduce their energy use.
- 4. Don't delay decoupling until the utilities have gone through rate cases. In DOER's view, delaying the implementation of decoupling until all utilities have gone through rate cases would make the perfect the enemy of the good. Unquestionably, it would be ideal to launch the decoupling regime on the basis of up-to-date information on revenue requirements, and new rate cases are long overdue. But the first order of business should be to unleash the consumer and associated benefits of energy efficiency, and that means putting decoupling in place. Rate cases can establish new utility revenue requirements, and the decoupling regime can be recalibrated based on the new information.
- 5. Implement decoupling through periodic rate cases, annual adjustments and more frequent reconciliations. In general terms, DOER proposes that decoupled revenues be established in the first instance with existing information on revenue requirements and, subsequently, in rate cases that take place at five-year intervals; that annual adjustments be made with reference to factors such as inflation and productivity changes; and that more frequent

reconciliations take place on a quarterly basis. Moreover, DOER does not believe that the number of customers is the best determinant of a utility's cost structure. We recommend that revenue requirements be established on a company-specific basis rather than on number of customers served.

II. Replies to Questions

DOER provides the following answers to questions posed by the Department, applicable to both electric and gas utilities unless otherwise noted. As a general principle, DOER favors consistent application of the base rate adjustment mechanism across all companies in the absence of compelling reasons to the contrary.

Allowed Revenues per Customer

1. The Department's proposal that a company's allowed revenues per customer be determined through a subsequent base rate proceeding is intended to ensure that the allowed revenue levels, which serve as the basis for the base revenue adjustment mechanism, are closely aligned with the company's costs. Under what, if any, circumstances should the Department permit a company's allowed revenues per customer to be determined through some manner other than a base rate proceeding?

As stated above in our summary comments, DOER does not support the use of a percustomer metric to establish revenue levels. We recommend that revenue requirements be determined on a company-specific basis and allocated to each rate class. With regard to the circumstances under which the Department should determine allowed revenues for distribution companies generally, and the timing applicable to those determinations, please refer to our answer to question # 12.

2. The Department's proposal uses an approach in which a company's allowed revenues per customer for each rate class does not change between base rate proceedings. An alternate approach would be to adjust the allowed revenues per customer values periodically, based on changes in each rate class' average usage per customer. Please discuss the merits of each approach.

Again, DOER does not favor the use of a per-customer metric. Average usage per customer (especially in terms of kWh) is not the only or the best determinant of a utility's cost structure. Allowed (as opposed to billed) revenues should only be adjusted by the Performance Based Rate (PBR) mechanism between rate proceedings or, in the absence of a PBR, they should not change during the period between rate proceedings.

Annual Reconciliation Calculation

3. The Department's proposal that a company's actual versus allowed revenues be reconciled annually is intended to balance three objectives: rate stability, rate continuity, and administrative efficiency. Do annual reconciliations strike an appropriate balance among these three objectives or would alternate reconciliation periods (e.g., quarterly or semi-annually) better do so?

DOER believes that quarterly reconciliations strike the appropriate balance among these three objectives.

4. The Department's proposal to determine a company's actual revenue based on billed revenues is consistent with the base rate treatment applied to distribution-related bad debt costs. An alternate approach would be to determine actual revenues based on payments received. Please discuss the merits of each approach.

DOER is still evaluating this question, and does not offer an answer at this time.

- 5. The Department's proposal for determining billed revenues is based on actual consumption. An alternate approach would be to determine billed revenues based on consumption normalized for weather and/or other factors.
 - (a) Please discuss the merits of determining billed revenues using actual versus weather-normalized consumption.
 - (b) Should consumption be normalized for other factors (<u>e.g.</u>, economic conditions)? If so, identify those factors and describe how the normalization for such factors could be done.
- (a) *Allowed* revenues are already normalized for weather in that base rate proceedings determine revenue levels using a weather-normalized test year. Therefore, *billed* revenues

should not be further normalized for weather. Additionally, determining billed revenues using actual consumption reduces complexity and the administrative burden on the utilities.

(b) DOER does not recommend normalization for non-weather exogenous factors.

The effects of these factors can be ascertained in the proceedings in which allowed revenue levels are adjusted.

Annual Base Rate Adjustment

6. The Department's proposal to recover the difference between a company's target and projected revenues through adjustments to its base energy charges is intended to send appropriate price signals to consumers. An alternate approach would be to adjust both base energy and demand charges (where applicable) to recover this difference. Please discuss the merits of each approach.

A key objective of the adjustment mechanism is to maintain variability in rates in order to enable customers to respond to appropriate price signals. Applying the adjustment mechanism to the base energy charge or to both energy and demand charges maintains this variability. However, in our view adjusting the base energy charge rather than the base energy charge *and* the demand charge sends the appropriate price signal. Inclusion of the demand charge adds little to this signal and compounds administrative complexity.

Reconciliation Filings

- 7. The Department's proposal to require a company to submit quarterly filings identifying actual and allowed revenues is intended to ensure that changes in rates are made in a predictable and gradual manner.
 - (a) Under what circumstances should the Department allow an adjustment in base charges during a reconciliation period?
 - (b) Under what circumstances should the Department initiate a review of a company's base revenue adjustment mechanism?
- (a) For clarification, we interpret the term "base charges" to mean both base energy and demand charges. DOER does not recommend adjustments between reconciliation proceedings, which we believe should be quarterly. More frequent adjustments will simply

increase price volatility for ratepayers and increase the administrative burden on the utilities.

Conversely, less frequent adjustments (such as annual) may lead to overly large and burdensome changes in customers' bills.

- (b) As stated in our summary comments, DOER believes that performance-based ratemaking should be utilized to create incentives for utilities to increase the deployment of energy efficiency measures as well as to improve productivity and service delivery. In the absence of any such performance-based approach, we recommend review of a utility's base revenue adjustment to assure that such incentives are adequately addressed.
- 8. What standards should the Department use to measure the performance of a company's base revenue adjustment mechanism over time?

See reply to Question #7.

Change in Risk

9. How will the implementation of a base revenue adjustment mechanism affect a company's risk and how should such considerations be reflected in a company's capital structure and ROE?

DOER believes that utilization of a base revenue adjustment mechanism will lower the utilities' risk over the long term and, also over the long term, the reduced risk should be reflected in a lower return on equity (ROE). The risk reduction should be perceived by capital markets as adding value, thereby reducing the cost of debt to companies and, ultimately, reducing costs to ratepayers. However, it is appropriate to move cautiously with respect to any reduction in ROE until there is real information on how the capital markets respond to the new decoupled regime.

Shared Earnings Provisions

10. The Department's proposal to include a shared earnings provision in the base revenue adjustment mechanism is intended to strike an appropriate balance between the risks borne by customers and shareholders associated with company earnings. Please comment on

the merits of such a provision. Also, comment on the design of the proposed earnings sharing provision.

The Department proposes earnings sharing and base rate proceedings every three years. However, DOER believes a better approach is an annual PBR adjustment with a shared earnings provision and base rate proceedings every 5 years. If the Department elects to forgo PBR and conduct frequent rate cases (such as at the suggested interval of every 3 years), we see no substantive risk to customers and shareholders, nor a need for such a sharing mechanism. Further, the Department's mention of 300 basis points to trigger the shared earnings mechanism is far too wide. 300 basis points on a 10% ROE would provide a 30% increase in a utility's ROE with no sharing of profits with customers. We suggest 200 basis points or fewer should the Department put in place a shared earnings mechanism.

Performance Based Regulation

11. Please comment on the merits of implementing a base rate adjustment mechanism with and without the individual elements of a PBR plan (<u>e.g.</u>, fixed term, inflation, productivity, performance standards, exogenous factors).

In DOER's view, a well-designed PBR plan should remain an important component in the ratemaking process. DOER recommends that the Department utilize company-specific PBR adjustments (on an annual basis) to change allowed revenue levels. The PBR adjustment would be applied during the period between base rate proceedings and would include the following components: (a) an inflation factor adjusted for productivity, (b) a component to account for certain exogenous factors, (c) a service quality provision and (d) an energy savings adjustment factor that would reward (or penalize) the utility based on the level of energy efficiency savings it achieves. The alternative to a PBR plan is the use of frequent and aggressive rate cases to address these factors.

Implementation Schedule

12. Please comment on how the Department should schedule the implementation of a base revenue adjustment mechanism for each gas and electric company in light of the need to move expeditiously, the resources required to implement such changes, and the specific circumstances of each company. How should the Department determine the order of individual base rate proceedings?

Given the settlements and PBR plans currently in effect, DOER recommends that the Department implement a two-phase process to put in place the new decoupled rate structures as soon as practical rather than requiring full base rate proceedings in the base revenue adjustment mechanism as a precondition to decoupling. The first phase would establish generic rules to implement decoupling for all distribution companies. The second phase would address individual companies, and would re-establish test-year allowed revenues by updating rate base and revenue requirement levels (see section above). DOER believes that full base rate proceedings are not necessary to establish decoupled rate designs and raterecovery mechanisms that promote demand-side resources. After the generic rules are established in the first phase, the Department should use existing revenue levels and cost allocations to rate classes to create the new decoupled rate structures. Rate design for these companies could be fully modified to maximize energy efficiency. Base rate proceedings would then be conducted at regular intervals to ensure that companies are making prudent investments that advance the policy goals of the Commonwealth. With few exceptions these intervals should not exceed 5 years, and companies that have had base rate proceedings in the last 5 years should be placed last on the queue for any new rate proceeding.

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¹ Exceptions should be allowed for extremely cost-efficient or high-service-quality companies, or companies facing significant capital upgrades.

Other Questions

How should the implementation of a base revenue adjustment mechanism affect the 13. performance-based shareholder incentives that gas and electric companies currently are

eligible to receive for promoting energy efficiency?

Implementation of a base revenue adjustment mechanism provides no incentives to

promote energy efficiency; rather, it only makes the utilities financially neutral with respect

to increased use of energy efficiency and other demand-side resources. Incentives will still

be necessary to promote increased deployment of demand-side resources. At a minimum,

existing shareholder incentives must be maintained. As described above, DOER believes

that the current incentive scheme needs to be expanded (with the possible inclusion of

penalties for poor performance).

Respectfully submitted,

COMMONWEALTH OF MASSACHUSETTS

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